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Farm Loan Bonds Under the Rural Credits Act

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LONG-TIME MORTGAGE BONDS

BONDS secured by pledging with a trustee, mortgages payable over a long period of time in equal annual or semi-annual installments, are growing in favor. They are comparatively new in this country, but have been common in Europe for over a hundred years. Bonds issued by the federal land banks and joint stock land banks under the Rural Credits Act of June 16, 1917 are bonds of this type. The amortization or repayment of mortgage loans by annual or semi-annual installments over a long period of time has not been applied to loans on city property to any extent in this country, although the building association plan of small monthly payments on the shares of stock in the association, belonging to the borrower, who must also be a stockholder, resembles the plan of amortization by equal annual or semi-annual installments. The monthly payments on the shares may be applied by either the association or the borrower in payment of the mortgage loan.

Bonds of this type are almost invariably secured by farm mortgages and are issued by corporations and individuals loaning on farm mortgages as well as by federal land banks and joint stock land banks, under the Rural Credits Act.

Where the bonds are issued by corporations or individuals, the mortgages are pledged with a trustee as collateral, and the annual or semi-annual pay-

ments are apportioned to principal and interest in accordance with a plan or table of amortization, covering the amount of the loan and the number of years selected by the borrower for the repayment of the entire principal with interest. The greater the number of years, the smaller the annual or semi-annual payments, and the amount of the periodic payments applicable to payment of interest on the loan grows constantly less. The principal paid off is usually reinvested in mortgage loans and the mortgages pledged as collateral with the trustee, in order that the value of the collateral in the hands of the trustee shall always be equal to the amount of the bonds outstanding.

AMOUNT OF FARM LOAN BONDS

The bulk of the bonds of this type, however, in this country are farm loan bonds issued by federal land banks and joint stock land banks. The consolidated statement of the condition of the twelve federal land banks at the close of business on November 30, 1919, shows that the amount of farm loan bonds authorized was \$286,100,000 and the consolidated statement of the condition of the thirty joint stock land banks in this country at the close of business on November 30, 1919, shows that the amount of farm loan bonds authorized was \$56,135,000. These amounts are being constantly increased by new issues approved by the federal farm loan board.

THE RURAL CREDITS ACT

Regulation of Issues

The Act of June 16, 1917 known as the Rural Credits Act, throws every possible safeguard around farm loan bonds issued by the federal land banks and joint stock land banks. The government farm loan system, inaugurated by the act, is built around two types of land banks, federal land banks and joint stock land banks, both under the supervision of the federal farm loan board. This board consists of five members, including the Secretary of the Treasury and four members appointed by the President. It has the power to appoint the farm loan registrars for each district, land bank appraisers and land bank examiners, and may grant or reject the application of a federal land bank or joint stock land bank for leave to issue bonds.

Federal Farm Loan Districts

As required by the act, the federal farm loan board has divided the continental United States, excluding Alaska, into twelve districts and federal land banks have been incorporated and have commenced business in each district. The federal land bank in each district is required to include in its title the name of the city in which it is located. Federal land banks are now operating in Springfield, Mass., Baltimore, Md., Columbia, S. C., Louisville, Ky., New Orleans, La., Omaha, Neb., Wichita, Kans., Houston, Tex., Berkeley, Cal., Spokane, Wash., St. Paul, Minn. and St. Louis, Mo.

Minimum Capital

Each federal land bank is a federal corporation and must have a minimum

capital of \$750,000 divided into shares of \$5 each. The shares may be owned by individuals, firms, corporations or by the government of any state or of the United States. The United States government, however, receives no dividends on its stock, as the government subscription was primarily to insure the formation of a federal land bank in each district.

The act provides that after the subscriptions to the capital stock of any federal land bank by national farm loan associations shall amount to \$750,000 the bank shall apply 25 per cent of all future subscriptions to the capital stock, to the retirement of the original capital at par. It is undoubtedly intended that national farm loan associations shall eventually be the only stockholders of federal land banks. Only stock held by the government and by national farm loan associations has voting rights.

Federal Land Bank Reserves

Federal land banks and joint stock land banks are both required to build up reserves by carrying to a reserve account 25 per cent of net earnings until the account shows a credit balance equal to 20 per cent of the outstanding capital, and such balance must be restored, in case of impairment, before any dividends can be paid. After this reserve has reached the sum of 20 per cent of the outstanding capital, then 5 per cent of net earnings must annually be added to it. This is a wise and conservative provision of the act and it protects the bondholder, for it is further provided that, in case of default, for a period of two years, in payment of interest, amortization installments or principal on any loan

made by a federal land bank or joint stock land bank, the amount so defaulted shall be debited to this reserve account. While the care taken in placing loans makes it practically certain that such arrearages will be recovered in foreclosure proceedings, the proviso that the amount defaulted shall be debited to the reserve account keeps the collateral intact in the hands of the registrar. There is no provision in the act for double liability of stockholders of federal land banks, although this double liability is imposed on stockholders of national farm loan associations.

Appraisal of Security Offered by the Farmer

The most striking provision of the act is the extreme care taken to insure an accurate appraisal of the farmer's land and buildings offered as security for the loan to the farmer, and to obtain the benefit of local knowledge as to the moral hazard.

HOW LOANS ARE MADE BY FEDERAL LAND BANKS

Loans can be made by federal land banks only through national farm loan associations, consisting of ten or more farmers who are also borrowers or intending borrowers and, in districts where national farm loan associations have not been organized, through agents. Such agents must be banks, trust companies, savings banks or mortgage companies, chartered in the state where their principal offices are located. The agent must endorse loans made through it by the federal land bank and loans from an agent can not exceed ten times its capital and surplus.

Limitations on Use of Money Borrowed

Loans to farmers can only be made to the extent of 50 per cent of the appraised value of the land and 20 per cent of the permanent insured improvements on the land offered for security, and the uses to which the farmer may apply the proceeds of his loan are limited by the act and clearly set forth therein.

The secretary of the national farm loan association is required to inform the federal land bank loaning the money of any failure on the part of the borrower to properly apply the proceeds of his loan. Under the act, loans may be made to farmers (a) to provide for the purchase of land for agricultural uses, (b) to provide for the purchase of equipment, fertilizers and live stock necessary for the proper and reasonable operation of the mortgaged farm, (c) to provide buildings and for the improvement of farm lands and (d) to liquidate indebtedness. The use of the money borrowed from a federal land bank, on farm mortgage, under the act, for any other purpose or purposes constitutes a breach of covenant, for which the bank may demand payment of the loan and in event of non-compliance with the demand, institute foreclosure proceedings. The purpose sought to be accomplished by the framers of the act in making the national farm loan associations a part of the system, was, clearly, to obtain for the federal land bank the benefit of local knowledge as to the character of the borrower, the value and condition of the farm to be mortgaged and local conditions affecting the loan.

NATIONAL FARM LOAN ASSOCIATIONS

The national farm loan associations are corporations, in many respects very

similar to the building and loan association well known in the larger eastern cities, with a board of directors empowered to elect a president, vice-president and a loan committee of three members. The board of directors also chooses a secretary-treasurer and fixes his compensation. The secretary-treasurer need not necessarily be a member of the association, however. The secretary-treasurer must collect, receipt for and transmit to the federal land bank making the loan, payments of interest, amortization installments or principal arising out of loans made through the association and must report to the bank any failure on the part of the borrower to comply with the terms of his application or mortgage.

Membership of a Farm Loan Association

Every member of a national farm loan association must be a borrower and he must subscribe to shares of the association of the par value of \$5, to the extent of 5 per cent of the amount of his loan, although the purchase price for his shares may be included in the loan if this does not increase the loan beyond the limits laid down in the act. A member's shares are held by the association as collateral for his loan but the member receives the dividends and when the loan is paid off the shares are paid off and retired at par.

Double Liability of Shareholders

Shareholders of every national farm loan association are personally liable for its debts to the extent of the stock severally held, in addition to the amount paid in and represented by their shares. This is the double liability so familiar in the case of shareholders in national banks. This double

liability extends to all obligations of the association and it is therefore applicable to mortgages given by members of the association. The mortgages given by members of the association to the federal land bank making the loan are endorsed by the association, the association thus making itself liable for any deficiency in case of foreclosure.

Amount of Reserve Required

National farm loan associations are required to accumulate a reserve equal to 20 per cent of their outstanding capital account, by carrying to a reserve account each year, a sum not less than 10 per cent of its net earnings. After a reserve of 20 per cent is accumulated, then 2 per cent of net earnings is to be added to the reserve annually. Whenever the reserve is impaired the credit balance of 20 per cent shall be fully restored before any dividends are paid. In case of the voluntary liquidation of a national farm loan association, a sum equal to its reserve account must be paid to and become the property of the federal land bank in which the association is a shareholder. The reserve, therefore, is an additional safeguard for the loans made by a federal land bank to members of national farm loan associations.

First Mortgage Loans

Loans are made by federal land banks only on first mortgages and the loan committee of the national farm loan association, when the loan is made through the association, must first report favorably on the loan before the federal land bank will refer it to one or more of the appraisers appointed by the federal farm loan board. The appraiser must make a written report

favorable to the loan before the loan can be made by the bank.

A national farm loan association borrowing for a member from a federal land bank must subscribe for capital stock of the bank to the amount of 5 per cent of such loan. The stock, however, is held by the bank as collateral security for the payment of the loan, the association receiving the dividends. When the loan is paid off the stock is cancelled.

Earnings of Farm Loan Associations

As dividends paid by the federal land banks are the only source of earnings for national farm loan associations, fairness to borrowers requires that dividends shall be paid. If the borrower includes the amount necessary to pay for his association stock in his loan, he would actually receive on a loan of \$1,000, only \$950, for which he would pay at the rate of $5\frac{1}{2}$ per cent on the whole thousand dollars or a rate of over 5.7 per cent, if he receives no dividend on his stock in the national farm loan association. If he receives a dividend of 6 per cent on his stock, however, the interest rate on his loan is reduced to a little less than $5\frac{1}{2}$ per cent. Dividends at the rate of 6 per cent have already been paid by six of the federal land banks and more will be added to the list within a short time. Borrowers through an approved agent of a federal land bank must subscribe for capital stock of the bank making the loan, to the extent of 5 per cent of the amount of their loan.

Amortization Plan for Repayment of Loan

The act provides, "that every mortgage must contain an agreement pro-

viding for repayment of the loan on an amortization plan by means of a fixed number of annual or semi-annual installments, sufficient to cover, first, a charge on the loan, at a rate not exceeding the interest rate in the last series of farm loan bonds issued by the land bank making the loan; second, a charge for administration and profits, at a rate not exceeding 1 per cent per annum on the unpaid principal, said two rates combined constituting the interest rate on the mortgage; third, such amounts to be applied on the principal as will extinguish the debt within an agreed period, not less than five years nor more than forty years. No loan on mortgage to be made at a rate of interest exceeding 6 per cent, exclusive of amortization payments."

The minimum and maximum amount of loans to any one borrower is fixed by the act at \$100 and \$1,000. But the federal farm loan board in its last report strongly urged that these limits should be made \$500 and \$25,000.

SECURITY FOR FARM LOAN BONDS

The farm mortgages securing loans made with such care and under such stringent regulations are available as collateral security for an issue of farm loan bonds by the land bank making the loan. The mortgages are deposited with the farm loan registrar appointed by the federal farm loan board for each land bank district and the land bank must make written application to the farm loan board through the registrar for approval of such issue of bonds. The farm loan board after appraisal of the security offered by the land bank, grants, in whole or in part or rejects entirely, such application. If the application to issue farm loan bonds is

granted, the mortgages remain in the hands of the registrar as trustee for the bondholders and the bonds are issued by the federal land bank making the application.

Bonds Issued

The bonds are coupon bonds in series of not less than \$50,000, to be paid and retired according to rules and regulations prescribed by the federal farm loan board and are redeemable at the option of the issuing bank at any time after five years from the date of issue. The bonds issued to date are payable in twenty years and are issued in denominations of \$25, \$50, \$100, \$500, and \$1,000. Bonds may not be issued in excess of twenty times the capital and surplus of the issuing bank.

Liability of Federal Land Banks

The act provides, "That every federal land bank issuing farm loan bonds shall be permanently liable therefor, and shall also be liable, upon presentation of farm loan bond coupons, for interest payments due upon any farm loan bonds issued by other federal land banks and remaining unpaid in consequence of the default of such other land banks: and every such bank shall, likewise, be liable for such portion of the principle of farm loan bonds so issued as shall not be paid after the assets of any such other land bank shall have been liquidated and distributed: Provided, that such losses, if any, either of interest or of principal, shall be assessed by the federal farm loan board against solvent land banks liable therefor in proportion to the amount of farm loan bonds which each may have outstanding at the time of the assessment." This security is of course in

addition to the security given by the pledged mortgages and all other assets of the issuing land bank. It is hard to see how any loss can come to the holders of such bonds.

The annual or semi-annual payments are made by the mortgagor to the land bank making the loan and if the mortgage is pledged with the registrar, the payments on account of principal constitute a trust fund in the hands of the land bank or joint stock bank receiving the same and must be applied or employed in the manner directed by the act, in purchasing farm loan bonds, lending on first mortgage or in the purchase of United States government bonds. The application of such funds, directed by the act strengthens the security of the farm loan bonds outstanding, as the farm loan bonds, first mortgages, United States government bonds or cash, constituting the trust fund must be deposited with the registrar in trust, as substituted collateral in the place of the sums paid on account of the principal of mortgages held by the registrar in trust.

BOND ISSUE OF JOINT STOCK LAND BANKS

Security.—The act also provides for the issue of bonds by joint stock land banks, secured by the deposit of first mortgages on farm land with the registrar. The joint stock land banks are corporations authorized by the act, incorporated for the purpose of carrying on the business of lending on farm mortgages and issuing farm loan bonds. They are federal corporations and may be formed by any number of natural persons, not less than ten. They are not authorized to commence business until capital stock to the amount of

at least \$250,000 has been subscribed and one half paid in cash and the balance subject to call by the board of directors. A charter must also have been issued to it by the federal farm loan board.

Stock Ownership.—The stock of joint stock land banks may be owned by individuals, firms and corporations, but not by the United States government, and each shareholder has the same voting privilege as shareholders in national banking associations. The capital must be entirely paid up before the bank may issue bonds. Stockholders have double liability for all obligations of joint stock land banks, including farm loan bonds issued by the particular bank in which they are stockholders.

Bond Issues.—The bonds of joint stock land banks must be issued in series of not less than \$50,000, and in denominations of \$25, \$50, \$100, \$500, and \$1,000. They are to be paid and retired in accordance with rules and regulations prescribed by the federal farm loan board and bonds issued to date are payable in twenty years. The joint stock land bank issuing farm loan bonds has the right to redeem them at par and interest on any interest date after five years from issue. The interest rate can not exceed 5 per cent. The bonds are the direct obligations of the joint stock land bank issuing them and no bank is responsible, in any way, for the bonds of any other bank.

Rate of Interest.—Joint stock land banks have the same restrictions as federal land banks with respect to the rate of interest they can charge on mortgages, but the rates are not subject to review by the federal farm loan board and they are not restricted as to the amount of each loan nor as to the purpose for which the money loaned may be used by the borrower. The borrower must be a farm owner, however, and the loans must be on first mortgages on farm lands within the state in which the principal office of the bank is located, or within some one state contiguous to such state.

Amount of Bond Issue.—No joint stock land bank may issue or obligate itself for outstanding farm loan bonds in excess of fifteen times the amount of its capital and surplus. The bonds issued by joint stock land banks are secured by the deposit of approved first mortgages on farm properties with the registrar and the procedure for the issue of joint stock land bank bonds is the same as in the case of federal land bank bonds.

Tax Exemptions.—The bonds of both federal land banks and joint stock land banks are free of all federal and state taxes, including income tax, and are unquestionably investments of the highest merit. The bonds of federal land banks yield, at the present time, about 4.35 per cent to optional date and the bonds of joint stock land banks yield about 4.50 per cent to optional date.